

CARIBBEAN DEVELOPMENT BANK



DEVELOPMENT BANKING: CHALLENGES AND OPPORTUNITIES OVER THE DECADE

ADDRESS

by

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I. INTRODUCTORY BACKGROUND

There has been more than 50 years of development banking experience in the Caribbean. It started in 1951 with the establishment of the Development Finance Corporation in Jamaica. Under one name or another, development banking institutions spread across the Caribbean in the 1970s. By 1980, virtually every country had a development banking entity.

Development banking was a deliberate public policy initiative to accelerate economic growth and social and economic development by facilitating more access to investment capital by business enterprises. The existing conditions were a financial sector comprised almost entirely of highly risk averse commercial banks operating as short term lenders to established businesses mainly in commerce. The *raison d'être* for development banking is to be found in discordance between the credit allocation practices of the private financial institutions and the financial requirements for rapid and sustained economic growth. The era was one of plantation agriculture, mineral enclaves and oligopolistic market structures in foreign trade and commerce. Governments when confronted by the social and economic challenges presented by slow and unstable economic growth, sought strategic solutions in terms of economic diversification and development of small farm agriculture. These sectors and sub-sectors did not attract funding from commercial banks. The creation of development banks was the answer. Caribbean development banks are State-owned enterprises, with only one or a few exceptions. Governments appoint their Boards of Directors and through this mechanism can hold them accountable for their performance as well as provide policy directives.

II. ROLE OF DEVELOPMENT BANKS

There are four functions or aspects of the role of development banks to be especially noted here. One function is to mobilise funds for onlending to domestic enterprises. Sources of funds have been highly liquid statutory corporations such as national insurance boards, the sub-regional development bank, i.e. CDB, and extra-regional financial institutions and governments. The national development banks do not perform depository functions. Acceptance of deposits from the public would place them under the regulatory control of central banks and would most likely reduce their ability to leverage their liabilities. Cost of funds would also increase because of the need to provide support services for deposit account transactions.

A second function is to lower the cost of credit for investment purposes by price-setting policies which are not intended to maximise profits. The requirement is that they operate on the principle of pricing that is concessionary by comparison with the pricing policies of commercial financial institutions. Third, development banks are expected to apply social cost-benefit principles in their appraisal of investment projects submitted by clients. Externalities, particularly social and economic, which would be extraneous to commercial banks' considerations, are often central to development banks' appraisal of projects. For development banks, a project worthy of financing must not only be viable, it must also

contribute to national development. In this latter regard, development banks apply national development criteria on behalf of government.

A fourth aspect of the role of development banks is inducing entry into the investment finance segment of the market by demonstrating opportunities for relatively safe and remunerative medium and long term lending. This role is very important. It recognises that development banks cannot satisfy all of the demand for investment capital, that there will be room for other financiers.

III. EXPERIENCE OF DEVELOPMENT BANKING

Development banks in the Caribbean have been successful in funds mobilisation and in the provision of investment capital. Small and medium-size enterprises in agriculture, manufacturing and tourism have benefitted especially. The development banks have also extended the scope of their credit activities to include student loans.

Loan recovery has been a problem. The problem stems from the stance taken by many borrowers that loans provided by State-owned banks are *de facto* non-repayable grants. Furthermore, efforts by development banks to enforce loan contracts are hampered by weaknesses in judicial administration, especially lengthy delays in judicial determination. Government influence on decisions has sometimes been another problem. The serious threat has not been undue influence on particular credit applications but the stipulation of credit guidelines which lead to over-exposure to particular industries or sectors.

IV. THE NEXT ECONOMIC DECADE

The first problem or challenge of the next economic decade is that of revival of economic growth. The nature and pace of the recovery would be an overall constraint on the operations of development banks. The prospects for recovery are uncertain. Many Western Hemisphere economies have had to revise their growth forecasts downwards. There is also uncertainty about the degree to which economic recovery in Caribbean countries will lag behind economic recovery in their industrialised trading partners.

It is possible that commercial banks, including the indigenous ones, will become more risk averse in response to the liquidity and earnings problems of Caribbean enterprises. Some financial institutions have such a high level of exposure to government debt that they are adversely impacted by fiscal difficulties which erode governments' debt servicing capacity. The overall prospect is for reduced access to commercial lenders and greater recourse to development banks in the short term.

There is the question of what structural shape the economies will take as the decade progresses. The loss of European trade preferences for the staple agricultural exports is forcing economic planners to consider questions such as agricultural diversification, rationalisation of agricultural industries including contraction, and orientation of production towards domestic markets including the growing tourism demand. In tourism, there seems to be an emerging trend towards mega hotels and condominiums rather than the small, owner-operated hotel enterprises favoured in the past. In several countries, consideration is also being given to developing the services sector as an exports sector to counter the declining trend in merchandise exports. Whatever the structural shape that emerges, development banks will have to deal with an economic environment considerably different from the one to which they have been accustomed.

Most Caribbean governments are under severe pressure to reform their public finances. Their debt levels have approached unsustainability necessitating efforts to lower debt levels and reduce debt service burden. Furthermore, because of heavy borrowing in the past, there is less scope for tapping the liquid resources of public financial enterprises like national commercial banks and statutory pension funds and social security funds. Instead, additional debt financing by the governments is more likely to be from multinational commercial banks and multilateral financial institutions.

The final consideration I would advance here is the completion of the Caricom Single Market and Economy (CSME) and its implications for national economic structures, markets and industries. Completion of the CSME would certainly mean integration of markets for goods and services, capital and labour. There is the likelihood that cross border transaction would increase and that there would be more cross-border Caricom enterprises.

V. CHALLENGES FOR DEVELOPMENT BANKS

Development banks are likely to be seriously challenged in this decade. On the lending side of their operations, one challenge is competition from commercial banks and merchant banks. The growth in size of non-financial enterprises and the associated growth in the average size of their loan demands will bring them into a range which attracts the interest of private financial institutions. Paradoxically too, the success of development banks in demonstrating the feasibility of doing good investment financing business will also encourage the interest of potential competitors. Development banks should see these prospects as both challenges and opportunities. The opportunities inhere in the possibility of joint financing arrangements in which development banks bring their comparative strength in appraising and monitoring investment projects. In situations of competition, development banks would need to increase their average loan sizes to remain competitive. If they do not, there is the danger of their clients outgrowing them. Larger loan sizes might generate reductions in unit costs which would provide scope for competitive loan pricing and higher rates of return.

Another challenge on the lending side is the greater complexity of enterprise risk evaluation when the enterprises are cross border enterprises operating in non-uniform regulatory and legal jurisdictions. On the funding side, development banks may increasingly need to rely on their own financial strength for market access of funds since governments may become reluctant to guarantee their debt and might not have the debt bearing capacity or sufficiently strong credit ratings. If development banks are to rely on their own financial strength, it becomes imperative that they become more efficient and that they adopt loan pricing policies which ensure adequate rates of return on their asset portfolios.

Development banks should also consider engaging their traditional funding partners on different modalities of funding as alternatives to lines of credit. For instance, consideration could be given to fixed term debt and to bond issues both of which might lower costs of funds mobilization and transactions costs associated with reporting on lines of credit.

VI. FINAL REMARKS

There is no question that the Caribbean will be confronted with many serious challenges in the present decade and that development banks as instruments of social and economic development will be called upon to help enterprises and governments address them. At the same time, the changing environment challenges the development banks to modify their policies, *modus operandi* and behaviour in order to maintain a meaningful place in the configuration of financial institutions and development institutions.